CFA Institute

Investing vs. Speculation: Highlights from the Future of Finance Forum

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Categories: Behavioral Finance, Equity Investments, Fixed Income, Portfolio Management, Private Wealth Management

THE FUTURE OF FINANCE STARTS WITH YOU

Under the auspices of the Future of Finance project at CFA Institute — a long-term global effort to shape a trustworthy, forward-thinking financial industry that better serves society — I moderated the organization's first-ever online discussion on 15–19 July to debate "What is the difference between investing and speculating — and why does it matter?" Our esteemed panelists included: Harold Bradley; Tom Brakke, CFA; Margaret Franklin, CFA; and Robert Hagstrom, CFA.

In total, the discussion featured well more than 200 posts from the panelists. The conversation was wide-ranging, engaging, informative, and even entertaining. Of course, it also produced a lengthy transcript with a wealth of insights and perspectives. To help guide you to the essence of the discussion, here is my attempt, as moderator, to provide a summary.

What is the Difference Between Investing and Speculating?

Harold Bradley, former Ewing Marion Kauffman Foundation CIO

Most actions in the world of finance are speculative, according to Bradley, who put forth the case that behavioral finance helps provide an explanation:

"Behavioral finance notions of confirmation bias, over (and under) reaction to information, prospect theory (loss aversion), hindsight bias and anchoring all provide compelling insights into why we have slipped into a state where Wall Street kicks up a new asset class (diversifier) with big fees every two or three years. And why we, as institutional investors, always bite at the apple."

Bradley thinks that additional responsibility for rampant speculation rests on those market participants who ignore returns on capital and instead focus on asset allocation decisions. He provided the example of farmland in which "expected yields are about 2%." So "speculation occurs because sophisticated, smart people stop at the diversification benefit and don't look at the yield."

Bradley's views on speculation are perhaps best summarized by his statement that "speculation [is] a form of perceived risk management that is predicated on the wrong things — and often driven by narrative fallacies that rely on limited amounts of data presented on charts as asset allocation 'hot buttons.'"

To my knowledge this use of behavioral finance to help define the difference between investing and speculating is charting new territory. Way to go, Harold!

By contrast, Bradley contended that "[investing] is long only, for a long duration, using no borrowed money where there is a dividend or income stream that rewards patient capital and appreciation at or above the inflation rate is a happy accident."

Tom Brakke, CFA, investment consultant and blogger

Brakke used the analogy of the tortoise and the hare to compare speculators to investors. He also pointed out that many supposed investor activities can be considered speculative because choices are made about possible future outcomes, which are unknowable in advance.

He also held up the absence of careful consideration of economics as an example of speculation. "The glossing over of . . . numbers has been a pretty reliable sign that speculative activity has overwhelmed analysis," Brakke argued.

Among the panelists, Brakke seemed to orient most to a relativistic philosophy. Put another way, he believes notions of investing and speculating change depending on current conditions in the marketplace. Brakke contended that the behavior of the industry as a whole (i.e., when individual opinion herds into a stampede) is always in flux and affects perceptions about investing and speculating. Activities that were previously considered speculating by a wide swath of market participants suddenly become "investing" when most are engaging in the previously taboo behavior. Case in point: The dot-com era, when speculation turned into a widespread investor belief that "it's a whole new world."

Brakke also took his thoughts about the difference between investing and speculating outside of the analyst/investment manager context:

"While [asset managers] say they want individuals and organizations to be 'investing,' meaning participating in the markets, their business models are trend-chasing ones, selling what can be sold for an attractive fee."

As for responsibility, on multiple occasions Brakke argued that a misalignment of incentives between firms and their clients has led to much of the speculative behavior. Again, Brakke has taken the discussion of differences between investing and speculating into new frontiers.

Margaret Franklin, CFA, president of Marret Private Wealth

As a private wealth manager, Marg Franklin offered a few insights, chief among them: “At the highest level, absolute objectives — not relative — are critical to client success. That includes time horizon, fundamental assessment of risk (not simply standard deviation), realistic return expectations, etc.”

She also offered some definitions:

“Investing is predicated on thoughtful, comprehensive, and reasonable analysis of the securities you are purchasing and the portfolio being created against the return you expect to receive — which can come in myriad forms: interest, dividends, capital appreciation. Speculation, in contrast, is based on conjecture rather than fact-based analysis — ‘greater fool’ comes to mind unless it is insider trading. Either case, it is fraught with more risk.”

Robert Hagstrom, CFA, Legg Mason Investment Counsel’s chief investment strategist

Of the panelists, Hagstrom was most interested in actually defining the differences between investing and speculating. He highlighted the importance of intentions and behaviors. For example, if your intention is to profit from the change in prices based on the behavior of market participants, then you are speculating. If, on the other hand, your intention is to profit from a change in value of an underlying asset, then you are investing.

“There has to be an assessment of value to be constituted as investing,” he wrote. “An investor thinks foremost of the asset first then the price of the asset afterwards.”

In contrast, he wrote:

“Speculation is about anticipating changes in individual attitudes towards the market and/or an investment independent of what the underlying asset is worth then it seems to me we need to first corral those strategies that seek to anticipate or predict changes in individual behavior. In other words, we are looking for strategies that source their return from shifts in attitude." Similarly, "A speculator thinks foremost of price first and then the asset later or not at all."

What Causes Speculative Behavior?

Other issues percolated through the core discussion. Chief among them was the many outside pressures faced by market participants that lead to speculative behaviors. Among them: central banks having distorted the price discovery of interest rates; short-term focused clients; short-term focused consultants; ignorant and politicized boards of directors; and academic notions of finance that lead investors to focus on statistics (such as beta) rather than on asset fundamentals.

That the discussion frequently turned to these tangential issues is an indication that all participants think that finance needs repair — in fact, three of the four panelists said so directly.

Still, there is the possibility of redemption for finance, despite its remarkably low trust levels with the general public. Each panelist said they feel that finance and capitalism are great goods for humanity.

Best Suggestions

- Harold Bradley recommended the creation of an alignment scorecard by and for industry professionals. The scorecard would measure how closely investment managers' fiduciary duties were in alignment with their clients' needs.
- Robert Hagstrom called upon CFA Institute to lead an industry-wide discussion to carefully define what qualifies as investing and what qualifies as speculating. He argued that if these standards are established, it would be easier for practitioners, regulators, journalists, and the public to understand whether decisions and behaviors belong in the investing column or the speculating column — and to respond in a more informed manner.

Favorite Quotes

Harold Bradley

- "I believe speculation to be embedded in almost all forms of investment today."
- Sarcastically said about investing in hedge funds: "I don't want to hire a consultant constrained small cap money manager because that [asset allocation] box is full BUT I will gain diversification benefits by paying 2% management fees, 20% carry on a non-transparent portfolio because the guy sounds smart and his lack of constraints help with non-correlation of assets."
- On how to improve finance to better serve the greater good: "I would require all people dealing with other people's money to be organized as partnerships." Why? Because "at partnerships, leverage threaten[s] everyone around the table. At corporations, someone bails them out."

Tom Brakke, CFA

- "Given the prevalence of speculative activities…is the market a wildly inefficient place?"
- "Clients have gotten the idea that they come second, not first."

Marg Franklin, CFA

- "For the record, [asset manager] fees have to be commensurate with a net benefit to the client."

Robert Hagstrom, CFA

- "How is it an accountant can tell me the difference between debits and credits; a lawyer can define the differences between a felony and a misdemeanor; and a doctor can tell me what is the difference between a bacterial infection and a viral infection but we in the financial industry cannot answer . . . what is the difference between investing and speculation[?]"